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M A N A G E M E N T   L E T T E R

DATE: June 23, 2003

TO: Metropolitan King County Councilmembers

FROM: Cheryle A. Broom, County Auditor

SUBJECT: Follow-up Review on Financial-Related Audit of Information and Telecommunications Services Infrastructure Operating and Maintenance Costs

This letter presents the results of our follow-up review of the financial management practices for the county's wide area network (WAN). The purpose of the follow-up was to determine the progress the Division of Information and Telecommunications Services (ITS) has made in implementing previous audit recommendations directed at improving cost accounting procedures, budgeting, management controls, and compliance with applicable accounting standards for internal service funds.

In our follow-up, we found that ITS has made numerous improvements in its procedures and management controls since the audit. The division has improved its accounting to track the costs of services and implemented a detailed rate-setting methodology. It has also increased accountability for costs by publishing its rates and general methodology on the county intranet.

We also noted where further improvements could be made. ITS allocates a disproportionate amount of overhead to the rates for the WAN, which distorts its service rates. This amount is identified in ITS's rate model, and division management said that they will bill the amount out as a separate rate in the future. In addition, the division's fixed asset list was incomplete, due in part to weaknesses in the IBIS accounting system. ITS is mitigating the problem by utilizing the ARMS system to account for equipment purchases, which has better controls over fixed assets.

SCOPE AND METHODOLOGY

The follow-up reviewed the implementation status of key recommendations from the financial-related audit of ITS Infrastructure Operating and Maintenance Costs (Report No. 98-06). The audit had concluded that ITS had not implemented sound cost accounting procedures and as a result, was unable to set accurate rates for the WAN ("Infrastructure") and e-mail. The audit also found that ITS did not have adequate controls over its fixed assets and was unable to produce a current list of fixed assets.

For this follow-up we conducted a limited review of: ITS's methodology for setting the 2003 rates; ITS revenues and expenditures for 2002 and 2003; ITS financial statements; the ITS fixed asset inventory report; and the procedures for recording and accounting for fixed assets. We

also interviewed staff from ITS, Personal Property Services in Fleet Management, and the Finance and Business Operations Division. We would like to express our appreciation to those staff and to the management of ITS for their cooperation during our follow-up.

BACKGROUND

The Data Processing Internal Service Fund is used to account for the WAN and many of the other services that ITS provides, such as web services, e-mail, system development and programming, mainframe support, data entry, server maintenance and backup, and local area network (LAN) support. Internal service funds are used for services that are intended to recover their costs through customer charges. ITS rates use different methodologies to allocate costs, depending on the service. For example, rates for the WAN are charged to all county agencies, based on the number of FTEs in each agency; e-mail rates are based on the number of e-mail accounts. Programming rates are hourly, with charges set in Service Level Agreements with the agencies needing that service. ITS charges for services totaled $20,365,634 in 2003.

CONCLUSIONS AND RECOMMENDATIONS

- ITS has created new cost centers to account more accurately for the cost of each service it provides.

A major finding of the previous audit was that ITS could not determine the costs of providing services because it used one cost center to track expenditures for multiple services. ITS has since created new cost centers that capture the direct costs of each service it provides, as well as the division's administrative and management costs. Accurate tracking of costs is the basis for setting appropriate rates, consistent with the cost-reimbursement principle of internal service funds.

- ITS does not have written policies and procedures for setting service rates.

ITS has developed a detailed methodology for capturing its costs and setting rates since the audit. Although we recommend some changes in the methodology (see the next bullet), the framework for the methodology is sound and can be adjusted to reflect management decisions for setting rates. However, ITS does not have written policies governing the rate structure or written procedures for the rate-setting model, despite its complexity. We recommend that ITS develop written policies and procedures for the rate-setting methodology and assumptions used. (See also the discussion of rate policy under the following bullet.)

- The rates for ITS services do not reflect the actual costs of the services because most of the division's overhead costs are included in the WAN rate.

ITS charges for its services in order to recover costs, both direct and indirect. The direct costs of each service are included in that service's rates, but administrative costs are recovered in several ways. ITS includes a portion of administrative costs as overhead in all of its service rates; it also charges for administrative services to ITS sections that are not in the Data Processing Internal Service Fund, and to the Office of Information Resource Management (OIRM). These allocations do not recover all of the administrative costs, however, and the remaining amount is combined into the WAN rates.

For example, ITS allocated only a portion of overhead among the service rates for 2003, and some overhead costs were allocated entirely to the WAN, such as the ITS retirement reserve of

$580,000. ITS also undercharged other funds for their share of overhead. We estimate that an additional $260,000 should have been charged to these other funds, including Radio Communications, the Institutional Network (I-Net), the Office of Cable Communications, and OIRM.

As a result of these practices, the WAN rates bear most of the division's overhead costs. Overhead costs made up 41 percent of the amount that was charged out for the WAN in 2003, while the overhead rates of the other ITS services ranged from 7 percent to 15 percent. Using the WAN to subsidize other services creates a rate system that distorts the relative costs of services. Ultimately, this means that county management does not have good information for making decisions regarding those services.

ITS management said that this method of allocation was intended to encourage agency use of the services provided through service level agreements, i.e., application development and support, server maintenance and backup, and LAN support. Their concern was that fully loading those rates with overhead costs might create the perception that it would be more economical for agencies to hire their own information technology (IT) staff, without recognizing the costs that ITS incurs to provide its staff with supervision, training, backup, and standardized development procedures consistent with the county's IT environments. They also noted that allocating a percentage of administrative overhead to non-WAN services was new to the 2003 rate model; many were not allocated any administrative overhead in 2002.

ITS management indicated that they will change the billing methodology in 2004. Instead of including all unallocated overhead in the WAN rates, ITS will break out this amount and charge it directly to agencies, based on their FTEs. This is the same billing methodology as the WAN rates, so agencies will not see a difference in the overall amount they pay to ITS. However, billing the unallocated overhead separately will add transparency to the service rates.

Audit staff assessed the impact of allocating the overhead more evenly among ITS services. We revised the overhead allocation based on the number of FTEs in each service, but other methods could also result in a reasonable and fair allocation. Under the revised allocation, the total amount charged out for the WAN would decrease from $9.5 million to $6.4 million, while the other service rates would increase. The rate for hourly services would increase from $68 to $94 per hour. The revised allocation would also shift the amount paid by CX and non-CX agencies. Based on the current pattern of consumption of ITS services, we estimate that CX agencies' share of the service charges would increase from 37 percent to 39 percent, and the amount paid by CX agencies for ITS services would increase by approximately $286,000.

Audit staff recommend that ITS management develop a clear rate-setting policy that articulates the rationale for the rate structure. We also recommend that ITS indicate the composition of the overhead that it will bill out directly in 2004, such as administrative costs, division management, the specific internal service charges, charges for office space occupied by administrative staff, and the retirement reserve. Finally, we recommend that ITS revise the allocation of overhead costs to other funds that receive administrative services from ITS, including Radio Communications, I-Net, and the Office of Information Resource Management, and allocate a proportionate share of administrative overhead to Cable Communications which is a current-expense-funded program.

- ITS did not adjust its rates based on actual expenditures.

As with other internal service funds, ITS rates are set to recover projected expenditures for the coming year. If actual expenditures are above the budgeted amounts, service charges will be inadequate to meet expenditures; if actual expenditures are lower than projected, customers are overcharged. Because internal service funds are supposed to operate on a cost-reimbursement basis, without profit or loss over time, the rates should be adjusted based on the difference between the budgeted and actual expenditures and consistent with the fund's financial plan.[1]

ITS does not adjust its rates based on actual expenditures (after adjusting for variances that affect established rates, e.g. encumbrances) to correct the under or over charges billed to its customer-agencies. ITS projected expenditures of $22.6 million in setting its 2002 rates, while actual expenditures in 2002 were $21.6 million. The variance consisted of $0.5 million unused contingency, which is not part of the rates, $0.2 million encumbrances to carry over to 2003, and $0.3 million underexpenditures. ITS did rebate a total of $952,000 to user agencies in 2003. However, the rebate, which was initiated by ITS and approved by the Budget Office, was a one-time directive and not part of ITS's rate-setting methodology.

Accordingly, we recommended that ITS adjust their rates annually to reflect actual expenditures from the prior year. ITS indicated that they will include this in the rate-setting process beginning in 2004.

- ITS's fixed assets inventory report is incomplete and balances are not reconciled with the financial statements, thus increasing the potential for losing county assets.

Part of safeguarding the county's assets is establishing adequate controls over fixed assets, that is, items that cost $1,000 or more. When equipment that meets the $1,000 criterion is purchased, it should be recorded as a fixed asset in one of the county's two financial accounting systems (either ARMS or IBIS) and in the county's fixed assets system, which produces an inventory report listing the assets.

In our follow-up we found that some data processing equipment, accessories, and other equipment purchased by ITS in 2001 were not recorded in the fixed asset inventory report. We sampled twelve pieces of this unrecorded equipment and found that none of them were counted during the physical inventory of fixed assets conducted by ITS staff in 2002. However, when we asked ITS staff to look for the assets, they were able to locate all but one of the items.

One reason why the items were not on the inventory report is that the IBIS system does not interface with the fixed assets system. The agency buying the asset is supposed to fill out an asset acquisition form with the asset details, including description, location, cost, and tag number. This form is sent to the Finance and Business Operations Division (FBOD), which manually enters the information into the fixed assets system. The delay or failure by ITS staff to send the acquisition form and/or by FBOD staff to enter the data caused the fixed assets inventory report to be incomplete and inaccurate.

ITS management indicated that they are mitigating this problem by using the ARMS system to account for equipment purchases. Unlike IBIS, when fixed assets are accounted for in ARMS they are automatically entered into the fixed assets system.

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[1] The financial plan should include reserves for emergencies and replacement of assets.

Moreover, the cost of ITS data processing and other equipment shown in the fixed assets system is not completely reconciled with the county's financial statements. The total cost of data processing equipment per the fixed assets system was $10,984,045, while the fixed assets balance in the financial statement was $13,678,452 in 2001.[2] The difference of $2,694,407 generally represents the cost of fixed assets that were purchased from 1998 through 2001 but not recorded in the fixed assets system. The unrecorded assets were primarily those that were accounted for in IBIS but not entered into the fixed assets system. Additionally, fixed assets that are purchased for capital projects must be manually entered into the fixed assets system, but this was not done for some assets that were acquired with bond proceeds for capital projects (e.g., WAN planning and design). FBOD prepares a reconciliation statement between the ARMS and IBIS systems and the fixed assets system. The statement identifies the cost of the assets not recorded in the fixed assets system; however, it appeared that there was no attempt to identify the actual assets and make the fixed assets system's inventory report complete and accurate.

We recommend that the Finance and Business Operations Division, in cooperation with ITS, produce a complete and accurate fixed assets inventory report. The Finance and Business Operations Division should regularly reconcile the fixed assets inventory report with balances in the financial statements and identify the assets that are not recorded in the fixed assets system.

Finally, we should note that inadequate controls over fixed assets was a repeat finding in the State Auditor's Office (SAO) audits of King County during the 1990s. The SAO noted both inadequate physical inventories and the lack of interface between IBIS and the fixed assets system. Implementation of the new Financial System Replacement Program (FSRP) that was supposed to correct the accounting system deficiencies was discontinued in 2001. As part of an IBIS upgrade, FBOD will look at how assets purchased in IBIS can be automatically recorded in the fixed assets system. We recommend that FBOD report to the council in September 2004 on the impact of the IBIS upgrade on the fixed assets system.

Bert Golla and Nancy McDaniel conducted this management review. Please contact them or me at 296-1655 if you have any questions about the issues discussed in this letter.

CB:NM:yr

cc: Ron Sims, King County Executive
      Paul Tanaka, County Administrative Officer, Department of Executive Services
      Sheryl Whitney, Assistant County Executive
      Kevin Kearns, Manager, Division of Information and Telecommunications Services
      Chris Richards, Chief Financial Officer, ITS
      Bob Cowan, Director, Finance and Business Operations Division
      Connie Griffith, Chief Accountant/Manager, Financial Management Section, FBOD
      Windell Mitchell, Director, Fleet Administration Division
      Dave Lawson, Manager, Executive Audit Services

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[2] We used the 2001 financial statement because that is the most recent audited financial statement.